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SEVENTH CIRCUIT RULES THAT LENDER'S TITLE INSURANCE POLICY DOES NOT COVER RISK OF INADEQUATE CONSTRUCTION FUNDING

Does a Lender's title insurance policy cover construction liens filed by unpaid contractors where the lender has discontinued disbursing its construction loan mid-stream due to insufficient funds to complete the project? In *BB-Syndication Services, Inc. v. First American Title Insurance Co.*, 780 F.3d 825 (7th Cir. 2015), the United States Court of Appeals for the Seventh Circuit has emphatically answered "No."

The *BB-Syndication Services, Inc. v. First American Title Insurance Co.* litigation arose from the financial collapse of a major Kansas City mixed-use construction project. At the inception of construction, a dispute arose between the general contractor and the owner-borrower regarding the cost of construction. The contractor claimed that design changes made by the owner and its architect entitled the contractor to a price increase of over $22M. If the contractor's allegations were true, then the construction project would be underfunded by over $22M. The borrower disputed the price increase, and construction continued while the dispute between the contractor and the borrower progressed through arbitration.

With knowledge of the potential funding shortfall, the construction lender chose to proceed with financing the costs of construction as it progressed. The lender continued to fund the monthly construction draws for over one and one-half years, before it finally elected to cease all further construction loan disbursements, citing the huge loan imbalance and other defaults by the borrower. By then, the lender had disbursed about $61M of its $86M construction loan. Construction stopped, unpaid contractors filed construction liens totaling millions of dollars against the property, and the borrower filed bankruptcy.

In response to the liens, which had priority under Missouri law, the lender made a claim against the title insurance policy that insured the priority of its mortgage. The lender demanded that First American pay off all of the liens under the loan policy's construction lien coverage. First American ultimately denied coverage on grounds that the lender's own conduct—ceasing all funding of construction and refusing to release undisbursed loan proceeds to pay the contractors—had caused the liens to be filed, triggering policy exclusion 3(a). Exclusion 3(a) bars coverage for liens and encumbrances that are "created, suffered, assumed, or agreed" to by the insured.

BB-Syndication ultimately filed suit against First American. The District Court granted summary judgment in favor of First American, holding that exclusion 3(a) barred all coverage for all of the construction liens. BB-Syndication appealed. In a pivotal opinion, the Seventh Circuit affirmed the District Court's decision, holding that the lender had "created" the liens.

Perhaps the most significant aspect of the Seventh Circuit's opinion is its reasoning. In the few court decisions in other prior cases facing this issue, the outcome has turned upon the following two factors: 1) the existence or nonexistence of a disbursement agreement between the construction lender and the title company; and 2) whether or not the lender had disbursed the entire loan amount. The Seventh Circuit expressly criticized the reasoning of those prior decisions, and charted its own course. The Court recognized that construction lenders typically possess the power to exercise significant control over the loan transaction and over the construction project, particularly with regard to the project's finances. The Seventh Circuit concluded that construction lenders have both the ability and the duty to investigate, monitor, and to ensure the construction project's economic viability, both at inception and throughout construction. The Court held that "[w]hen liens arise from insufficient funds, the insured lender has 'created' them by failing to discover and prevent cost overruns—either at the beginning of the project or later." Consequently, the Seventh Circuit adopted a simple rule that "exclusion 3(a) excludes coverage for liens that arise as a result of insufficient funds."

The lesson for construction lenders is clear. They can no longer rely upon title insurance as a safety net against construction liens that arise due to insufficient construction funding. Instead, they must rely upon their own due diligence and other financial instruments, such as third-party guarantees or performance bonds. On the other hand, title insurers can take comfort that they will not be left holding the bag when a construction lender decides to quit disbursing a construction loan due to insufficient funding.

Mr. Slawinski represented the First American Title Insurance Co. in the BB-Syndication Services, Inc. litigation. He may be contacted by telephone at 414-276-5000 or via e-mail at steve.slawinski@wilaw.com.